Buy This Beaten-Down REIT's 5.5% Yield for Capital Gains

Description

Artis Real Estate Investment Trust (TSX:AX.UN) is one troubled REIT trading near its 52-week lows after recently announcing a 50% distribution cut effective November 2018 to realign its pay-out to the obtaining internal economic fundamentals, but its new strategic plan and improving business conditions could soon eliminate the deep discount on its equity units, offering investors significant capital gains potential.

Artis REIT holds a well-diversified portfolio of 234 properties in the office, retail and industrial property segments spread across the United States (45%) and Canada (55%). The trust targets increasing its U.S. exposure to 60% of the portfolio over the next three years as it implements a new strategic plan announced on November 01.

The REIT's units trade at a deep discount of 35% to net asset value today, with a price to net book value multiple of 0.65 times and the new $0.045 monthly distribution offers an annualized yield of 5.45% for new investors.

The slower than desired recovery in Alberta's economy has been blamed for Artis' continued low office segment occupancy rates, which were reported at 81.7% for Calgary office, dragging down overall in-place portfolio occupancy rate to 91.2% by September 30, 2018.

To boost its unit holders' fortunes going forward, the REIT announced new strategic initiatives to deliver improved value to its unit holders on November 01.

The new strategic plan

Artis announced a massive distribution cut by 50% in November that will save about $83 million annually in retained cash flow. The REIT reported an increasingly unsustainable Adjusted Funds From Operations (AFFO) pay-out rate of 112.5% for the third quarter that was much worse than the 103% reported for the same quarter last year. With the new $0.045 a unit monthly distribution, 2019 AFFO pay-out is estimated at an amazingly safe 53%.

Further, Artis is intensifying its repurchases of outstanding units through a current normal course issuer bid (NCIB) which would be funded, first from in place liquidity, then later from net proceeds from retained cash flow and asset disposals.

Most noteworthy, the REIT aims to dispose between $800 and $1 billion worth of non-core assets over the next three years. Non-core assets represent 17% of Artis' current property portfolio. Non-core asset sales are expected to generate net proceeds of $600 million to the REIT. The remaining portfolio will be of much better quality and could deliver better earnings and cash flow growth prospects.

I like Artis REIT's new focus on further reducing the trust's total debt ratio during this rising rate environment. Artis' debt to gross book value ratio stood at 48.6% by the end of last quarter, down from 49.3% by year-end 2017. The REIT targets a debt ratio of just 46% in the medium term and this can be easily achieved considering the new cash flow savings and planned asset disposal proceeds.

More gains from U.S. Fed signal

The unit price on Artis REIT rose more than 2% on Thursday as the U.S. Federal Reserve Chairman Jerome Powell seemingly reversed course on interest rate hikes by commenting that the Fed's policy interest rate is "just below" the targeted neutral level, which was a significant climb-down from his prior stance that rates needed to rise higher to reach a neutral level.

The neutral rate is the target interest rate that would sustain stable economic growth and employment while at the same time keeping price inflation in check. The signal for fewer interest rate increases over 2019 is a great boon for the REIT sector, even in Canada, as U.S. Fed's rate policy usually has significant influence on the local economy, and in turn, on Bank of Canada policy rates too.

Lower rate increases will keep financing costs relatively low and stable, offering great relief to highly leveraged firms, especially real estate operators.

Other strong positives

Artis returned to positive same property net operating income growth during the third quarter of 2018 after three consecutive quarters of negative growth and I expect a sustained improvement in this measure as the REIT increasingly focuses on its more profitable and stronger core portfolio.

Further, the REIT has a robust new property development program that could deliver strong cash flow and earnings growth into the future at a much lower cost than out-right acquisitions.

Investor takeaway

Artis REIT's new strategic refocus seems to have low execution risk, while the deep discount on the units' net asset value offers new investors a valuable margin of safety. As the new strategic plan rolls out, I would expect the valuation discount to disappear, and capital gains to be realized. Insiders are of likely of the same view too.

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